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SUBJECT: LITHUANIA'S ECONOMIC BOOM: IS THE END NIGH?

REF: A) 2005 Vilnius 769, B) 2005 Vilnius 528

¶1. SUMMARY: Lithuania's impressive economic growth continued in 2005. Wage increases, rising energy prices, and strong domestic consumption contributed to inflationary pressure, but a government budget surplus, improved credit rating, and a shrinking current account deficit indicate prudent economic policies. Foreign direct investment flows and U.S. accumulated investment plummeted in 2005, however. For the boom to continue, the GOL needs to improve its ability to attract foreign capital. END SUMMARY.

Growing Economy Continues to Impress

¶2. Lithuania's economy grew 6.9 percent in the first three quarters of 2005, boosting GDP to LTL 51.4 billion (USD 18.4 billion). (Final 2005 data will not be available until March.) This puts the country on pace to match the previous year's growth rate of seven percent, despite widespread expectations that the rate of economic growth would slow. Construction and consumer lending led growth, posting increases of 12 and 12.5 percent, respectively. Other sectors also saw significant gains: wholesale and retail trade (11.6 percent increase), hotels and restaurants (11.1 percent), transport and communications (10.9 percent), electricity, gas, and water supply (9.8 percent), and manufacturing (7.6 percent).

Challenges to Growth

¶3. Lithuania's economic growth continues in spite of several challenges. Record-high global oil prices and a rising cost of labor are pushing production costs higher. Economic stagnation among many of Lithuania's EU trading partners hampers the ability of Lithuanian companies to find new niches in their favorite markets. Increasing pressure from Chinese competition, especially in textiles and electronics, also challenges Lithuania's ability to export profitably.

Prudent Public Finances Keep Lithuania on the Euro Track

¶4. The GOL's fiscal position improved significantly during the first eleven months of 2005. Lithuania ran a budget surplus equal to 0.4 percent of GDP, in contrast to deficits of 2.5 percent and 1.7 percent in 2004 and 2003, respectively. Tight control over spending and a marked improvement in tax revenues explain this fiscal turnaround. (In one respect, there was in fact too much spending restraint; the GOL reneged at the end of the year on a commitment to NATO and the USG to increase defense spending, with a view to spending two percent of GDP on such expenditures within a few years' time.) Statisticians at the Ministry of Finance told us that the GOL may still end up in the red for 2005 because of increased spending in the fourth quarter, but statistics confirming this are not yet available. The GOL also kept the national debt under control: 16.9 percent of GDP for the first 11 months of 2005, well below the 60 percent limit required to meet the Maastricht criteria for joining the euro zone.

¶5. Lithuania's fiscal prudence looks set to continue, even though the 2006 budget is 20 percent larger than the budget for the previous year. If the government meets projected targets for revenue and expenditures of LTL 16.7 billion (USD 6 billion) and LTL 18.46 billion (USD 6.64 billion), respectively, the fiscal deficit will reach approximately 2 percent of GDP -- well under the Maastricht 3-percent ceiling.

S&P Confidence in Lithuania's Economic Policies

¶6. Standard & Poor's raised Lithuania's long-term foreign-currency borrowing rating last month from A- to A and its short-term rating from A-2 to A-1. This vote of confidence in the government's fiscal abilities should send a powerful signal to investors and allow the GOL cheaper access to foreign capital.

Unemployment Declines, as Workers Leave. . .

¶7. The unemployment rate continued to drop in 2005. The GOL's official registered unemployment rate for 2005 was 4.8 percent, down from 6.8 percent in 2004 and the lowest level of registered unemployment since Lithuania's transition to a market economy in the mid-1990s. The Statistics Department's more comprehensive quarterly survey data showed that unemployment dropped to its lowest rate in four years -- 7.2 percent in the third quarter -- a sharp decrease from 11.4 percent unemployment in 2004. Emigration of labor (especially unskilled labor departing for the UK and Ireland), rather than robust job creation, appears to account for much of the drop in unemployment. This trend looks likely to continue as entry restrictions to the EU's labor market relax further.

. . . and Wages Rise to Make them Stay

¶8. Lithuania's average gross monthly salary increased 9.4 percent in the third quarter of 2005 over the same period in 2004, which was also characterized by a strong rate of increase. Competition for labor from foreign markets and the shortage of qualified employees will continue to push wages higher in 2006. Wage increases contributed to inflation; consumer prices rose an estimated 2.7 percent by the end of November. This was slightly less than 2004's 2.9 percent inflation, but near the highest rate permitted under Maastricht.

FDI Plummets

¶9. Foreign direct investment (FDI) flows into Lithuania plummeted 28.2 percent during the first ten months of the year to LTL 1.32 billion (USD 447 million) -- LTL 519 million (USD 187 million) less than the first ten months of ¶2004. Accumulated FDI reached LTL 17.5 billion (USD 6.3 billion), or LTL 5,139 (USD 1,848) per capita. Leading investors were Sweden (14 percent), Denmark (13.5 percent), Germany (13.3 percent) and Russia (12.1 percent). U.S. investments accounted for less than five percent of the total FDI inflow, making it the seventh largest investor in Lithuania.

¶10. The total stock of U.S. FDI in Lithuania dropped by more than 30 percent in the first half of 2005, to LTL 740 million (USD 261 million). Officials in the Lithuania Statistics Department told us that approximately 60 percent of this decrease is the result of intracompany debt transfers involving local subsidiaries of U.S. companies. The head of a prominent local investors' advocacy group told us that she was unaware of any American-owned business that has pulled up stakes and left Lithuania recently. She added, however, that she was not surprised by the drop in FDI inflows and said that the GOL fails to make attracting investment a priority.

EU Membership Spurs Exports, Shrinks CAD

¶11. The current account deficit (CAD) deficit reached LTL 3.6 billion, or 6.9 per cent of GDP, in the first three quarters of 2005, down from 8.4 percent of GDP for the same period in 2004. Lithuanian exporters continued to enjoy the export benefits of EU membership, including market access to all EU member states and subsidies for exports to third countries. Lithuania's foreign trade deficit increased by 15.3 percent compared with the first ten months of 2004, to LTL 8 billion (USD 2.9 billion). Exports of goods and services grew by 25.8 percent to LTL 26.3 billion (USD 9.48 billion), while imports rose by 23.2 percent to LTL 34.4 billion (USD 12.3 billion). Lithuania faces a serious challenge from China and other Asian countries in many sectors, but its ability to supply goods to the European market faster than Asian countries remains a niche advantage.

¶12. Current transfers, especially EU funds and remittances from Lithuanians working abroad, played a key role in reducing the CAD. These transfers rose more than 56 percent in the first three quarters compared to the same period in 2004, totaling LTL 1.3 billion (USD 448 million).

Comment

¶13. Lithuania remains one of Europe's most dynamic economies. A few weaknesses, however, threaten to ground this high-flying economy in the coming years. With the exception of EU funds, this government has been complacent

in the global competition for capital. The fall in U.S. FDI reflects several problems, including the country's imperfect investment climate, the failure of the GOL to make headway against corruption, and massive labor flight. It also reflects Lithuania's institutional inadequacy in effectively promoting its advantages and attracting investors, especially in the United States. The multiparty government seems more willing to rely on EU funds to stimulate the economy than to pursue a more aggressive reform agenda.

¶14. Qualifying for entry into the euro zone, the GOL's top economic policy objective, appears more likely every day. That accomplishment may help attract more investment eventually. The GOL needs, however, to begin planning its post-euro adoption economic strategy today.

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